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# Turning Slogans Into Tax Policy

Karen C. Burke

*University of Florida Levin College of Law, [burkek@law.ufl.edu](mailto:burkek@law.ufl.edu)*

Grayson M.P. McCouch

*University of Florida Levin College of Law, [gmcouch@law.ufl.edu](mailto:gmcouch@law.ufl.edu)*

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# TURNING SLOGANS INTO TAX POLICY

*Karen C. Burke\**

*Grayson M.P. McCouch\*\**

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## I. INTRODUCTION

Throughout his presidency George W. Bush has embraced tax cuts as the hallmark of his domestic policy agenda. During the early years of his administration he signed an unprecedented series of annual tax reduction measures into law. The Bush tax cuts have proved highly controversial. Sympathizers herald them as part of a grand strategy to promote capital formation and fundamental tax reform,<sup>1</sup> while critics decry them as symptoms of a fiscally reckless

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\* Warren Distinguished Professor, University of San Diego School of Law.

\*\* Professor, University of San Diego School of Law.

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assault on progressive taxation.<sup>2</sup> At this point, it is probably too early to reach definitive conclusions about the long-term effects of the Bush tax cuts, especially considering the uncertain prospects for extending those cuts beyond 2010. Nevertheless, it is possible to evaluate the rationales articulated by the Bush Administration for its tax cutting proposals, to compare those proposals with the outcomes that ultimately emerged from the legislative process, and to draw some preliminary lessons about the Administration's approach to tax policy.

This article examines the Bush Administration's tax cutting agenda by focusing on two discrete episodes: the 2001 quest for estate tax repeal, and the 2003 attempt to eliminate the shareholder-level income tax on corporate dividends. These seemingly disparate episodes reveal a common pattern in the Administration's portrayal of its proposals. In both cases, the Administration offered simplistic economic rationales based on speculative argumentation and unrealistically optimistic assumptions, without acknowledging the revenue costs and regressive distributional effects of its proposals. The Administration also diverted attention from risks and tradeoffs by using populist slogans to pitch its proposals in terms of fairness and economic opportunity. Despite the Administration's uplifting rhetoric and rosy economic assumptions, the legislative outcomes in 2001 and 2003 were driven largely by budget constraints and interest group politics. As a result, the final bills that President Bush signed into law fell far short of the lofty expectations raised by the initial proposals. In the face of rampant budget deficits, urgent claims on public resources, and growing inequality of income and wealth, the Administration's tax cutting agenda may be better understood in terms of politics and ideology than conventional tax policy.

The article proceeds in two parts. The first part analyzes the campaign to repeal the estate tax, focusing on economic rationales and rhetorical claims, and explains why the Administration was

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<sup>1</sup> See Ernest S. Christian & Gary A. Robbins, *Stealth Approach to Tax Reform*, WASH. TIMES, Nov. 1, 2002, at A21; Bruce Bartlett, *Bush's High Five*, NATIONAL REVIEW ONLINE, Feb. 10, 2003, [http://www.nationalreview.com/script/printpage.p?ref=/nrof\\_bartlett/bartlett021003.asp](http://www.nationalreview.com/script/printpage.p?ref=/nrof_bartlett/bartlett021003.asp); see also MICHAEL J. GRAETZ & IAN SHAPIRO, DEATH BY A THOUSAND CUTS: THE FIGHT OVER TAXING INHERITED WEALTH 271-72 (2005) (citing Grover Norquist's comments on the Bush Administration's tax cutting agenda).

<sup>2</sup> See GRAETZ & SHAPIRO, *supra* note 1, at 277 (noting long-term effort to "fundamentally restructure our nation's tax system by eliminating all taxes on wealth and income from wealth"); Daniel N. Shavero, *Reckless Disregard: The Bush Administration's Policy of Cutting Taxes in the Face of an Enormous Fiscal Gap*, 45 B.C. L. REV. 1285 (2004).

unable to achieve its goal of complete, permanent repeal in 2001. In a parallel fashion, the second part explores the Administration's proposal to eliminate the shareholder-level income tax on dividends, and describes how the proposal was transformed almost beyond recognition as it wound its way through the legislative process. The article concludes with a brief assessment of prospects for making the Bush tax cuts permanent and the resulting implications for federal tax policy.

## II. ESTATE TAX REPEAL

During the 2000 presidential campaign, George W. Bush embraced tax cuts, including repeal of the estate tax, as a signature issue. Upon his inauguration as President in January 2001, President Bush lost no time in putting those tax cuts at the top of his Administration's legislative agenda. Although his economic advisers were primarily interested in reducing income tax rates and viewed the estate tax as a relatively minor issue, his political advisers insisted on making estate tax repeal a centerpiece of the Administration's proposals.<sup>3</sup> With both houses of Congress under Republican control and budget projections showing unexpectedly large surpluses, the political climate for tax cuts was especially favorable. The focus of controversy was not whether to cut taxes but rather which taxes to cut and how radically to cut them. In its first major test of political will, the Administration put together a coalition of large and small business owners to promote its agenda, ensure unwavering loyalty, and fend off competing proposals.<sup>4</sup> The strategy paid off, and within five months President Bush signed estate tax repeal into law as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (the 2001 Act).<sup>5</sup>

The campaign to repeal the estate tax did not originate with the Bush Administration. Opposition to the tax gathered momentum during the 1990s, and bills to repeal the tax passed Congress in 1999 and again in 2000, but President Clinton vetoed the legislation on both occasions. By 2001, the arguments against the estate tax were already well rehearsed. For convenience, the case for repeal can be broken

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<sup>3</sup> See GRAETZ & SHAPIRO, *supra* note 1, at 138 (noting that giving priority to estate tax repeal was "a political decision, not an economic one").

<sup>4</sup> See *id.* at 154-67 (describing Tax Relief Coalition).

<sup>5</sup> Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (codified in scattered sections of 26 U.S.C.).

down into two sets of arguments relating to economic effects and fairness, respectively.

*A. The Economic Case Against the Estate Tax*

*Capital Formation.* At the heart of the economic case against the estate tax is the claim that the tax discourages work, saving, and investment, thereby reducing capital formation and impeding economic growth.<sup>6</sup> Although it is tautologically true that the estate tax reduces the amount of wealth passing from a deceased donor to noncharitable beneficiaries, the charges leveled against the tax rest on several crucial but unstated (and highly questionable) assumptions concerning the motives and behavior of donors and donees. For example, a prospective donor contemplating the estate tax might respond in either of two ways. On one hand, she might seek to mitigate the impact of the tax by choosing leisure over work and consumption over saving, even though this would constrain the total after-tax amount available for noncharitable bequests (a substitution effect). On the other hand, she might work harder, save more, and consume less in order to maintain a desired level of noncharitable bequests after taxes (a wealth effect). A priori, it is impossible to say which effect predominates.<sup>7</sup>

The effects of the tax also depend on the donor's motives for giving. If the donor accumulates wealth primarily to provide for her own future needs (a precautionary motive), any bequests are essentially accidental and the estate tax should not affect the donor's propensity for saving. If bequests are viewed as a deferred payment to the donee for services, companionship, or other signs of respect and affection (an exchange motive), and if the wealth effect predominates, the estate tax may actually increase the donor's saving since larger accumulations of wealth are needed to secure a desired level of benefits. Even if bequests are motivated by pure altruism, the effects of the tax are ambiguous.<sup>8</sup>

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<sup>6</sup> See DAN MILLER, JOINT ECON. COMM., THE ECONOMICS OF THE ESTATE TAX 19 (1998); Richard E. Wagner, *Federal Transfer Taxation: A Study in Social Cost* 5–10 (Ctr. for the Study of Taxation, 1993); see also William W. Beach, *The Case for Repealing the Estate Tax* (Heritage Found. Background No. 1091, 1996), available at <http://www.heritage.org/Research/Taxes/BG1091.cfm>.

<sup>7</sup> See William G. Gale & Joel Slemrod, *Rhetoric and Economics in the Estate Tax Debate*, 54 NAT'L TAX J. 613, 617 (2001).

<sup>8</sup> See *id.*; William G. Gale & Joel Slemrod, *Overview*, in RETHINKING ESTATE AND GIFT TAXATION 1, 43–44 (William G. Gale et al. eds., 2001); *id.* at 22–23 (noting paucity of knowledge about motives of very wealthy households and suggesting that

The donee's behavior must also be considered. A donee who receives a bequest may work less and consume more than she would in the absence of a bequest, or she may respond by investing the inherited funds and redoubling her work effort. Again, the effect of the estate tax is ambiguous.<sup>9</sup> The donee's use of inherited property should be compared with the government's use of funds collected through the tax. If the beneficiary would squander her inheritance while the government would use tax revenues to pay down the national debt or build infrastructure, the estate tax could actually increase total national saving.<sup>10</sup> Opponents of the estate tax refuse to acknowledge such a possibility, however, because it does not support their dogmatic assertions about the harmful effects of the tax. The point is not that the estate tax has no effect on capital formation, but rather that the current state of economic knowledge about bequest motives and saving behavior does not support the simplistic and exaggerated charges levied by the tax's opponents.<sup>11</sup>

*Double Taxation.* Another line of attack asserts that the estate tax amounts to improper double taxation of wealth that was already subject to income taxation when it was earned.<sup>12</sup> Despite its force as a rhetorical gambit, the charge of double taxation is inaccurate and misleading in two respects. First, the underlying assumption that all accretions to wealth are subject to income taxation during life is simply not true. To be sure, the estate tax base includes the value of wealth transferred at death, and a portion of that value may consist of amounts saved from previously taxed wages and investment income.

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"the richest households may well have different motives for, and patterns of, giving and wealth accumulation").

<sup>9</sup> See Gale & Slemrod, *supra* note 7, at 617; Gale & Slemrod, *supra* note 8, at 44–45. Anti-tax advocates sometimes imply that the estate tax destroys capital, noting that a liquidity-constrained donee may have to sell inherited assets in order to raise funds to pay the tax. In fact, however, the effect of the estate tax depends on the purchaser's behavior. If the purchaser simply diverts funds from an alternative investment, net private saving remains unchanged. If the purchaser curtails consumption to raise the funds, net private saving may actually increase.

<sup>10</sup> Anti-tax advocates often assume, explicitly or implicitly, that government is inefficient and public spending is inherently wasteful. See Shaviro, *supra* note 2, at 1288–89.

<sup>11</sup> See Gale & Slemrod, *supra* note 8, at 58 (noting that the supposed negative effects of the estate tax "lack definitive supporting evidence and in some cases seem grossly overstated").

<sup>12</sup> See ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* 127 (2d ed. 1995) ("Gifts represent a transfer of income that has already been taxed, and there is no reason to tax it again.").

In estates with appreciated assets, however, the unrealized appreciation is not subject to income taxation during life and would go completely untaxed but for the estate tax.<sup>13</sup> Capital appreciation appears to be heavily concentrated among the wealthiest households, which also happen to be most likely to incur an estate tax.<sup>14</sup> Conversely, the vast majority of estates with relatively little capital appreciation — the supposed victims of double taxation — fall completely outside the reach of the estate tax. If the problem is that the estate tax functions poorly as a backstop to income taxation of unrealized appreciation, the obvious solution would be to replace the existing estate tax with a deathtime capital gains tax, but this is hardly what the advocates of repeal have in mind.<sup>15</sup>

The second problem with the double taxation slogan is that it serves as a smokescreen. Although there is some overlap between the estate tax base and the income tax base, the same is true of many other forms of taxation, including taxes on real property and retail sales, not to mention payroll, franchise, and excise taxes. Logically, then, the objection to double taxation, if taken seriously, should apply with equal force to all of these taxes. Although the estate tax has several distinctive features, notably its contribution to the progressivity of the federal tax system,<sup>16</sup> there is no reason to single out this tax as a uniquely pernicious example of double taxation. Evidently, opposition to the estate tax stems not from an abstract principle against overlapping layers of taxation but rather from a specific hostility to taxing capital or the income it generates — or, perhaps, from a more general distaste for progressive taxation.

*Efficiency.* Advocates of estate tax repeal often argue that the tax is easily avoidable and raises little or no net revenue.<sup>17</sup> While the

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<sup>13</sup> Property acquired from a decedent generally takes a fresh-start basis equal to its fair market value at the date of death, even if the transfer is sheltered from estate tax by the marital deduction or the unified credit. See I.R.C. § 1014(a), (b).

<sup>14</sup> According to one study, unrealized capital gains at death represent 36% of the total expected value of all estates and 56% of the total expected value of estates of \$10,000,000 or more. See James M. Poterba & Scott Weisbenner, *The Distributional Burden of Taxing Estates and Unrealized Capital Gains at Death*, in RETHINKING ESTATE AND GIFT TAXATION 422, 439, 440 tbl.10-8 (2001).

<sup>15</sup> See Gale & Slemrod, *supra* note 8, at 55 (noting that repeal of estate tax without repeal of basis step-up “would expose a gaping loophole” in the income tax).

<sup>16</sup> See *id.* (describing the estate tax as “the most progressive tax instrument in the federal tax arsenal”).

<sup>17</sup> See DAN MILLER, JOINT ECON. COMM., COSTS AND CONSEQUENCES OF THE FEDERAL ESTATE TAX 16 (2006) (“[R]epeal of the estate tax will not result in a revenue loss for the federal government (and may even result in a net revenue

existing estate tax is far from ideal and therefore offers numerous opportunities for avoidance, especially in the area of valuation, only a caricaturist would describe the tax as “voluntary.”<sup>18</sup> Indeed, it strains credulity to claim that the tax is excessively burdensome and at the same time easily avoidable. If the complaint is that some taxpayers use sophisticated planning techniques to reduce their effective tax rate, it does not follow that the tax should be repealed altogether; a more plausible approach would be to reform the tax by closing loopholes, broadening the base, and adjusting rates and exemptions. Nevertheless, anti-tax advocates seem more interested in cutting taxes than in closing loopholes.<sup>19</sup>

Opponents of the estate tax often suggest that simply abolishing the estate tax would actually raise net revenue,<sup>20</sup> but this appears to be based more on wishful thinking than on solid evidence.<sup>21</sup> Claims that the estate tax currently raises little or no net revenue rest on speculative assumptions and shaky empirical foundations.<sup>22</sup> It is tautologically true, of course, that costs of compliance and

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gain).”); Beach, *supra* note 6 (“The estate tax raises little money and encourages inefficient tax-avoidance schemes.”).

<sup>18</sup> Cf. GEORGE COOPER, A VOLUNTARY TAX? NEW PERSPECTIVES ON SOPHISTICATED ESTATE TAX AVOIDANCE (1979). While some of the tax avoidance techniques discussed by Professor Cooper are no longer available today, it appears that many high net worth households fail to exploit opportunities to reduce their estate tax liability through lifetime gifts. See James Poterba, *Estate and Gift Taxes and Incentives for Inter Vivos Giving in the U.S.*, 79 J. PUB. ECON. 237, 252 (2001).

<sup>19</sup> The argument for abolishing an existing tax in response to its imperfections is not limited to the estate tax. The same argument could apply just as easily to any tax, although proponents seem primarily interested in attacking progressive taxes that bear on capital or capital income.

<sup>20</sup> See MILLER, *supra* note 17, at 16; Beach, *supra* note 6 (“The deficit actually would decline, since revenues generated by extra growth would more than compensate for the meager revenues currently raised by the inefficient estate tax.”); Wagner, *supra* note 6, at ii (“The repeal of the transfer tax would, over time, lead to gains in . . . other tax revenues that would exceed the loss of the revenue from the transfer tax.”).

<sup>21</sup> Some studies suggest that the revenue attributable to the estate tax may actually exceed total reported estate tax collections due to indirect income tax effects. See GRAETZ & SHAPIRO, *supra* note 1, at 181–82 (discussing Joint Committee on Taxation’s revenue estimates of effects of estate tax repeal).

<sup>22</sup> For example, one commentator, relying largely on pre-1982 law, speculates that historically, the net revenue raised by the estate tax “may well have been near zero, or even negative.” B. Douglas Bernheim, *Does the Estate Tax Raise Revenue?*, in 1 TAX POLICY AND THE ECONOMY 113, 115 (Lawrence H. Summers ed., 1987). For a more recent discussion, see Gale & Slemrod, *supra* note 8, at 37–39 (noting that by one estimate collection costs amount to around 7% of estate tax revenues).



administration, together with indirect income tax effects, should be offset against the estate taxes collected by the government in arriving at a net revenue estimate, but in the absence of reliable data concerning those offsets, any estimate of net revenue must be viewed with caution. If the real concern is the relative efficiency of the estate tax as a source of revenue, the estate tax should be compared with plausible alternative revenue sources such as the income tax. In terms of behavioral incentives and costs of administration and compliance, the estate tax may fare better than its detractors would care to admit.<sup>23</sup>

*Farms and Small Businesses.* According to its opponents, the estate tax poses a special threat to family farms and small businesses because the heirs may be forced to sell a farm or business at the owner's death, sometimes at a depressed price, to pay the tax.<sup>24</sup> This argument, buttressed with opinion surveys and anecdotes concerning the plight of farmers and business owners, has proved especially effective in whipping up anti-tax sentiment.<sup>25</sup> In fact, however, the scope of the liquidity problem posed by the estate tax appears to be grossly overstated.<sup>26</sup> The vast majority of farmers and business owners are completely exempt from estate tax and those who face a potential tax liability should ordinarily be able to meet deathtime liquidity needs from life insurance proceeds or another designated source of funds. In this respect, a farm or business is not essentially different

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<sup>23</sup> See Gale & Slemrod, *supra* note 8, at 32 (“[T]axes imposed at death may have smaller disincentive effects on lifetime labor supply and saving than taxes that raise the same revenue (in present value terms) but are imposed during life.”); *id.* at 37–39 (discussing estimates of collection costs compared to revenue raised by estate and income taxes).

<sup>24</sup> See MILLER, *supra* note 17, at 21 (describing the estate tax as “a primary reason why small businesses fail to survive beyond one generation” and asserting that “the estate tax has contributed to the failure of thousands of small and family-run businesses”); Beach, *supra* note 6 (“The estate tax hurts small business”); Wagner, *supra* note 6, at 20 (“[T]ransfer tax liability often requires that the business be sold to provide the means to pay the tax.”).

<sup>25</sup> See GRAETZ & SHAPIRO, *supra* note 1, at 50–51 (discussing “horror stories”); *id.* at 62–66 (discussing story of Chester Thigpen, “an elegant, 83-year-old African American tree farmer from Montrose, Mississippi”).

<sup>26</sup> See Jane G. Gravelle & Steven Maguire, *Estate Taxes and Family Businesses: Economic Issues* 3–5 (Cong. Res. Serv., Report No. RL33070, 2007) (estimating that in 2003, less than 1% of decedents with farm assets and less than 0.1% of business owners faced estate tax liquidity problem); see also GRAETZ & SHAPIRO, *supra* note 1, at 126 (noting difficulty of finding “a single case of a farm that had actually been sold to pay the estate tax”); Gale & Slemrod, *supra* note 8, at 47 (“[T]he vast majority of closely held businesses do not appear to face imminent demise because of estate tax considerations.”).

from any other prized asset that an owner wishes to pass on intact to heirs, and the estate tax is not essentially different from any other foreseeable deathtime expense. Furthermore, current law provides special estate tax relief for illiquid farm and business estates.<sup>27</sup> Any lingering concerns about liquidity could be addressed simply by raising the estate tax exemption or adjusting the rate schedule. More fundamentally, the liquidity problems posed by the estate tax pale in comparison to the far more daunting economic challenges confronting family farms and small businesses. Such enterprises often fail during the owner's life — or must be sold at death — for a host of reasons that have nothing to do with the estate tax: a farm or business may fail due to poor management or bad luck; it may be acquired or driven out of business by domestic or foreign competitors; the heirs may simply lack the necessary skill or motivation to continue the enterprise after the owner's death. Repealing the estate tax would do nothing to alleviate these problems but would eliminate the single most progressive element of the existing federal tax system.

### *B. The Rhetoric of Fairness*

For anti-tax advocates, there is no ambiguity or uncertainty about the goal of abolishing the estate tax. Starting from a position of moral clarity and unbounded self-assurance, they see no need to test their economic arguments against observed facts or qualify their conclusions to accommodate competing policy goals. Instead, their mission is to discredit the estate tax and mobilize political support for its repeal. To this end, opponents of the estate tax have worked assiduously to exploit popular misperceptions of the tax and frame the case for repeal in terms of morality and fairness.

*Public Opinion.* Opponents of the estate tax have been remarkably successful in shaping public perceptions of the estate tax. Opinion polls routinely show that the tax is widely unpopular, with 70% or more of the public supporting abolition of the tax.<sup>28</sup> Of course, these results may be overstated, given the notoriously multifaceted nature of public opinion and rampant confusion in matters of tax policy. People often hold inconsistent views on fiscal policy — for

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<sup>27</sup> See I.R.C. §§ 2032A (allowing special use valuation for certain real property used in a farm or business), 6166 (allowing deferred payment of tax), 6601(j) (providing special interest rate on deferred payments); see also I.R.C. § 2057 (providing deduction for qualified family-owned business interests for estates of decedents dying before 2004).

<sup>28</sup> See GRAETZ & SHAPIRO, *supra* note 1, at 122.

example, simultaneously favoring tax cuts, increased public spending, and balanced budgets.<sup>29</sup> Thus, professional pollsters can easily manipulate opinion polls by framing questions in ways that yield desired responses. For example, estate tax repeal draws much higher approval ratings when it appears as an isolated, abstract proposition than when it is juxtaposed with alternative tax cuts or reductions in popular spending programs like Medicare or Social Security.<sup>30</sup> Thus, opinion polls do not merely reflect public opinion but also can be used to shape it, and the results should accordingly be viewed with caution.<sup>31</sup>

To some extent, opposition to the estate tax feeds on popular misperceptions about the scope and operation of the tax.<sup>32</sup> Survey evidence indicates that almost half the population believes that most families will have to pay an estate tax; in fact, the tax falls on only 2% of all estates.<sup>33</sup> Among small business owners, around one-third believe that they will incur an estate tax liability.<sup>34</sup> Activists and politicians who oppose the estate tax exploit the gap between

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<sup>29</sup> See *id.*

<sup>30</sup> See *id.* (noting that polls in the late 1990s showed 70% support for estate tax repeal but also showed one-third or less in favor of using the budget surplus for tax cuts and larger numbers in favor of using the surplus for domestic spending programs); *id.* at 122–23 (noting low priority of estate tax cuts relative to alternative tax cuts); see also Jonathan Baron & Edward J. McCaffery, *Starving the Beast: The Political Psychology of Budget Deficits*, in *FISCAL CHALLENGES: AN INTERDISCIPLINARY APPROACH TO BUDGET POLICY* 221, 238 (Elizabeth Garrett et al. eds., 2008) (“[A]lthough people may support spending cuts in the abstract, they resist cuts in specific programs.”).

<sup>31</sup> See GRAETZ & SHAPIRO, *supra* note 1, at 121–28 (discussing use of opinion polls); *id.* at 122 (“[O]pinion polls are less authentic measures of public opinion than they are rocks that activists throw at one another. Having structured a poll to get people to say what they want to hear, activists then use the results to rally the faithful, get media attention, and intimidate potential opposition.”).

<sup>32</sup> Popular sentiment about the estate tax may reflect a fundamentally myopic view of tax cutting proposals. Survey evidence suggests that many people welcome even a small reduction in their own tax burden without regard for the relative benefits reaped by other taxpayers or the implicit burdens of deficit-financed tax cuts. See Larry M. Bartels, *A Tale of Two Tax Cuts, a Wage Squeeze, and a Tax Credit*, 59 NAT’L TAX J. 403, 410–11 (2006); see also Joel Slemrod, *The Role of Misconceptions in Support for Regressive Tax Reform*, 59 NAT’L TAX J. 57, 69 (2006) (noting that a “misconceived belief that most families pay estate tax” contributes to “widespread opposition to the tax”).

<sup>33</sup> See GRAETZ & SHAPIRO, *supra* note 1, at 125 (noting that “only a third [of Americans] believe that ‘only a few’ families” will pay an estate tax).

<sup>34</sup> See *id.* at 126 (noting even higher level of concern on this point among minority business owners).

perception and reality by referring to the estate tax as the “death tax”<sup>35</sup> and portraying the tax as a looming menace to families and businesses across the board.<sup>36</sup> An especially effective technique in this regard involves stories about “real” people who have (supposedly) suffered financial and emotional hardship as a result of the estate tax.<sup>37</sup> For anti-tax advocates, it does not matter if the facts are heavily embellished or even invented. The point of the stories is to persuade an audience by means of an emotional appeal and incidentally to shift the debate from dry, technical questions of tax policy to dramatic morality tales brimming with human interest. Stories, unlike economic arguments, convey a message that is unambiguous, easy to understand, and emotionally compelling.<sup>38</sup>

*Success as Virtue.* The estate tax has traditionally been defended on the ground that it promotes equality of opportunity by curbing excessive concentrations of inherited wealth. Opponents of the tax, however, turn the conventional argument about fairness on its head. Instead of focusing on the disparity of opportunity between heirs of wealthy parents and children who start out with nothing, they emphasize themes of upward mobility and unlimited opportunity to

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<sup>35</sup> See *id.* at 76–78 (discussing importance of “death tax” label and quoting a Republican staffer: “Estate tax sounds like it only hits the wealthy but ‘death tax’ sounds like it hits everyone. They focus grouped this a lot, and people viewed a ‘death tax’ as very unfair. You don’t have to be really rich to be worried about a death tax.”).

<sup>36</sup> See *id.* at 78 (quoting one member of Congress: “Where I am from, no one will ever be subject to the estate tax, but when I feel my support waning, I say ‘I’ll get rid of the death tax to protect you, your families, your farms’ — and I get cheers. Why should I try to educate them?”); *id.* at 82 (quoting Frank Luntz’s summary of anti-tax talking points from his book, *Conservatively Speaking*: “The Death Tax is simply unfair. It tells every American that no matter how hard you work or how wisely you manage your affairs, in the end the federal government is going to step in and take it away. The estate tax is double and, in some cases, triple taxation. It punishes hard work and savings, it fails to raise the kind of revenues that might conceivably justify some of the damage it causes. It has been destroying businesses and ruining lives for four generations.”).

<sup>37</sup> See *supra* note 25.

<sup>38</sup> See GRAETZ & SHAPIRO, *supra* note 1, at 81 (quoting Frank Luntz on storytelling: “A compelling story, even if factually inaccurate, can be more emotionally compelling than a dry recitation of the truth.”); see also *id.* at 50–61 (discussing “stories from the grassroots”), 230–32 (noting that “stories trump science”), 237 (“If economic debates are transformed into a storytelling endeavor, the target audience moves into a comfortable zone where the storyteller simply has to provide an issue they can relate to and values they embrace — not economic arguments they must struggle to understand.”).

become rich, invoking the mythology of the American Dream.<sup>39</sup> They tell uplifting stories about hardworking, thrifty small business owners, implicitly portraying economic success as a just reward for hard work and personal virtue. By the same token, the estate tax is portrayed by its opponents as fundamentally unfair — a penalty on success and a threat to the American way of life. This line of argument is both simplistic and disingenuous, for it elides awkward questions about winners and losers, wealth distribution, and relative tax burdens. Nevertheless, by framing the debate in terms of black-and-white morality, opponents of the estate tax have seized the rhetorical high ground, turned the notion of fairness against defenders of the tax, and tapped into a powerful current of populist anti-tax sentiment.

*Class Warfare.* In an era of growing inequality of pre-tax income and wealth, a highly progressive tax like the estate tax might be expected to gain popular support, but this does not appear to be happening.<sup>40</sup> Indeed, anti-tax advocates condemn the estate tax as a form of class warfare and denounce its supporters for practicing the politics of envy. Ironically, the estate tax, which is aimed at curbing excessive concentrations of inherited wealth, has come to be widely perceived as an instrument of discrimination against the rich. Yet it seems odd to view the super-rich as victims of class warfare or invidious discrimination, for the estate tax is targeted at them precisely because of their greater ability to pay (as well as greater opportunity to avoid the burden of income and other taxes). In principle, the charges leveled against the estate tax by its opponents apply with equal force to any progressive tax, and the battle over the estate tax may prove to be only the first skirmish in a much broader assault on the idea of progressive taxation. Because the estate tax is a conspicuously progressive component of the existing federal tax system, repealing the tax would inevitably make the system less progressive. In effect, abolishing the estate tax amounts to a massive

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<sup>39</sup> This mythology reflects a widespread strain of unrealistic optimism. Many Americans routinely overestimate their own wealth compared to others and exaggerate their chances of becoming richer. According to some surveys, around 40% believe they are or soon will be in the richest 1%. *See id.* at 119 (“[L]arge numbers of Americans are unrealistically optimistic about their relative and absolute economic circumstances. They underestimate the levels of inequality, overestimate their own wealth compared to others, and exaggerate their likelihood of moving up significantly and getting rich.”).

<sup>40</sup> *See id.* at 120 (“[G]ood times produce overwhelming pressure to cut taxes on the wealthy right along with the less fortunate. Americans think that they are going to join the party, so they don’t mind paying for the drinks.”).

tax cut for a few thousand of the richest families in America — an emblem, some might say, of the politics of greed.

### C. Budget Politics

The 2001 Act formally abolishes the estate tax, but it does so in a way that must have come as a surprise and a disappointment to many opponents of the tax. Under the 2001 Act, estate tax repeal comes with several strings attached. First, repeal is not scheduled to take effect until 2010, following a nine-year phase-out period. Then, at the end of the phase-out period, the estate and generation-skipping transfer taxes will terminate but the gift tax will remain in effect as a backstop to the income tax. In addition, the longstanding fresh-start basis rule for inherited property will be replaced by a poorly conceived and administratively unworkable carryover basis regime. Finally, and most importantly, under a special “sunset” provision, all of the foregoing changes are scheduled to expire automatically at the end of 2010, reinstating prior law for 2011 and succeeding years.<sup>41</sup> In short, estate tax repeal is officially on the books, but in the absence of further legislative action it will not occur until 2010 and then it will last for only one year. This outcome is a far cry from the immediate, complete, permanent repeal contemplated by opponents of the estate tax.

The bizarre timing of the estate tax cuts in the 2001 Act reflects the exigencies of budget politics. The Bush Administration insisted that estate tax repeal be included in the legislative package along with several large income tax cuts, but the cost of immediate repeal could not possibly fit within the cap on the total ten-year revenue cost agreed in the budget resolution.<sup>42</sup> By pushing the estate tax cuts to the end of the nine-year phase-out period, including carryover basis, and retaining a stand-alone gift tax, the drafters were able to squeeze the estate tax cuts to fit within the budget resolution.<sup>43</sup> The sunset

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<sup>41</sup> See Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901(b), 115 Stat. 38, 150 (reinstating prior law for 2011 and subsequent years “as if [the 2001 Act] had never been enacted”); see also Karen C. Burke & Grayson M.P. McCouch, *Estate Tax Repeal: Through the Looking Glass*, 22 VA. TAX REV. 187, 188–89 (2002).

<sup>42</sup> See GRAETZ & SHAPIRO, *supra* note 1, at 178–93 (discussing “paint-by-numbers lawmaking”).

<sup>43</sup> A further wrinkle involves the replacement of the state death tax credit with a deduction early in the phase-out period. This change, which incidentally shifted estate tax revenue from the states back to the federal government, provided “easy money” to reduce the estimated budget cost of the tax cuts. See *id.* at 209–11.

provision further reduced the cost of the package. Indeed, without the sunset provision, the 2001 Act could never have been enacted under the Senate budget rules.<sup>44</sup>

The sunset provision and other budget gimmicks in the 2001 Act have led to disruption, complexity, and uncertainty, both during the period leading up to 2010 and beyond. In the near term, shifting rates and exemptions call for constant review and revision of existing estate plans; the decoupling of estate and gift tax exemptions creates new distortions in lifetime giving incentives; and the phase-out of the state death tax credit disrupts the longstanding system of pick-up estate taxes at the state level.<sup>45</sup> Far from ameliorating the problems of the existing estate tax, the 2001 Act has exacerbated the burdens of planning and the costs of compliance.

Even more troubling, however, is the uncertainty about the future of the estate tax. Circumstances have changed dramatically since President Bush signed the 2001 Act into law in June 2001. Government spending on military entanglements, disaster relief, prescription drug benefits, and other programs has exploded; projected budget surpluses have turned into record deficits; and the President can no longer count on a Republican-controlled Congress to enact annual tax cuts. As a result, it is by no means certain that the scheduled repeal of the estate tax will actually occur in 2010, and the prospect of permanent repeal has faded. Nevertheless, the Bush Administration continues to press for permanent repeal, citing the uncertainty engendered by the impending sunset as an additional reason to repudiate the sunset provision. Indeed, from the outset the Administration has viewed the sunset provision as nothing more than a tactical gambit to stake out the largest possible package of tax cuts, with the expectation that those cuts would eventually become permanent. Thus the Administration has engaged in a bait-and-switch tactic, initially using the sunset provision to reduce the revenue cost of estate tax repeal and then insisting that the sunset be eliminated on the ground that leaving it in place would constitute a tax increase. In short, the Administration would like to achieve permanent estate tax repeal without ever acknowledging the resulting revenue cost.<sup>46</sup>

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<sup>44</sup> The conference agreement passed the Senate by a vote of 58-33. In the absence of the sunset provision, the legislation would have required a sixty-vote supermajority in the Senate to override a point of order under the Byrd rule. See Karen C. Burke & Grayson M.P. McCouch, *Estate Tax Repeal and the Budget Process*, 104 TAX NOTES 1049, 1050 n.11, 1052 (Sept. 6, 2004).

<sup>45</sup> See *id.* at 1056 n.74.

<sup>46</sup> See DANIEL N. SHAVIRO, TAXES, SPENDING, AND THE U.S. GOVERNMENT'S

The Administration's decision to put estate tax repeal at the center of its tax-cutting agenda is best explained in terms of politics and ideology rather than tax policy. The abstract idea of estate tax repeal proved useful in rallying support from anti-tax activists and business interest groups during the 2000 presidential election, and the fortuitous circumstances of projected budget surpluses and a Republican-controlled Congress offered President Bush a golden opportunity to make good on his campaign promises. With respect to the estate tax, however, the 2001 Act proved long on symbolism and short on substance. Although the Administration could claim that it had accomplished its mission by putting estate tax repeal on the books, the expected benefits of repeal remained remote and uncertain. The sunset provision, which was essential to secure passage of the 2001 Act, reflected a risky gamble by the Administration that the tax cuts could subsequently be made permanent. With the passage of time, the gap between the Administration's extravagant anti-tax rhetoric and the real impact of the 2001 Act is becoming increasingly clear. A few taxpayers of enormous wealth stand to gain far more from complete repeal (even if coupled with carryover basis) than from any plausible reform involving higher exemptions and lower rates.<sup>47</sup> For these fortunate few, it may make sense to hold out for permanent repeal. But for a much larger number of moderately affluent taxpayers, increasing the estate tax exemption would be just as effective as abolishing the tax, especially if they continue to receive a tax-free deathtime basis step-up for appreciated property. Accordingly, the Administration's hardline strategy of pushing for complete repeal appears to be losing political momentum. Although the future of the estate tax remains unsettled, the most likely outcome appears to be a pragmatic compromise in which the estate tax remains

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MARCH TOWARD BANKRUPTCY 51 (2006) ("In short, the baseline would be deceptively shifted without an honest accounting at any time."). According to the Joint Committee on Taxation, advocates of permanent repeal argue that "it was never anticipated that the sunset [provisions] actually would be allowed to take effect" and that "eliminating them promptly would promote stability and rationality in the tax law." STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2005 BUDGET PROPOSAL 11 (Joint Comm. Print 2004).

<sup>47</sup> Of 20,250 taxable estate tax returns filed in 2005, 1320 (6.5%) reported gross estates of \$10 million or more. These returns reported \$11.10 billion of net estate taxes payable, or 51% of the total amount (\$21.67 billion) shown on all taxable returns. See INTERNAL REVENUE SERV., ESTATE TAX RETURNS FILED IN 2005 BY TAX STATUS AND SIZE OF GROSS ESTATE, available at <http://www.irs.gov/pub/irs-soi/05es01fyx.xls>.



in place with a larger exemption and lower marginal rates. In the meantime, the uncertainty created by the 2001 Act provides full employment for the lobbyists and power brokers who mediate the flow of campaign contributions in exchange for political access.<sup>48</sup>

### III. DIVIDEND TAX CUTS

The 2001 Act by no means exhausted the Bush Administration's appetite for cutting taxes. As the budget outlook deteriorated and surpluses turned to deficits, the Administration argued that more tax cuts were needed to stimulate the economy. In January 2003, as part of a stimulus package, the Administration floated a proposal to eliminate the double taxation of corporate income by allowing individual shareholders to exclude dividends attributable to previously-taxed corporate earnings.<sup>49</sup> In economic terms, the Administration argued that a dividend exclusion would stimulate consumption, curb incentives for sheltering and retaining corporate earnings, and improve corporate governance. In terms of fairness, the dividend exclusion proposal was touted as an antidote for the corporate double tax, which allegedly discriminated against stock investments and deprived shareholders of access to corporate earnings.

Constrained by budget pressures and political crosscurrents, the Administration was unable to realize its ambitious goal of eliminating

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<sup>48</sup> See Edward J. McCaffery & Linda R. Cohen, *Shakedown at Gucci Gulch: The New Logic of Collective Action*, 84 N.C. L. REV. 1159, 1165 n.17 (2006) ("[T]he Senate, in particular, deliberately strung along the issue of estate tax repeal . . . in order to keep alive an issue of value in generating campaign contributions."). *But cf.* GRAETZ & SHAPIRO, *supra* note 1, at 251 ("[W]hile money was an essential ingredient of the repeal movement's success, campaign contributions were a comparatively small part of this story. Money had its greatest impact on estate tax repeal by facilitating . . . research and publishing, political organizing, and the propagation and dissemination of opinion.").

<sup>49</sup> See George W. Bush, Address Before a Joint Session of the Congress on the State of Union, 39 WEEKLY COMP. PRES. DOC. 109 (Jan. 28, 2003); Press Release, White House Office of the Press Secretary, Fact Sheet: President Bush Taking Action to Strengthen America's Economy (Jan. 7, 2003), *available at* <http://www.whitehouse.gov/news/releases/2003/01/print/20030107.html>. The Administration borrowed the substance of its dividend exclusion proposal from a 1992 Treasury Department study. See U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2004 REVENUE PROPOSALS 11-22 (2003) [hereinafter FY 2004 REVENUE PROPOSALS]; U.S. DEP'T OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE (1992) [hereinafter 1992 INTEGRATION STUDY].

the shareholder-level tax on dividends. Instead, what emerged from a tortuous legislative process was a temporary reduction in the tax rate on dividends and capital gains, which President Bush signed into law in May 2003 as part of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the 2003 Act).<sup>50</sup>

### A. Economic Effects

*Stimulus.* In framing its proposal as a dividend exclusion, the Administration chose an odd way to stimulate consumption, if this was the primary concern. The Administration may have hoped that exempting dividends from shareholder-level taxation would “help jumpstart a staggering economy, jolt stock prices upward, and release a cascade of corporate cash into the pockets of upscale consumers,”<sup>51</sup> but such a scenario seems unduly optimistic. The proposal provided relief only for individual shareholders (who receive only about one-third of all dividends<sup>52</sup>) and curtailed the exclusion to the extent dividends were paid from corporate income that was fully or partially sheltered at the corporate level. Moreover, since stock ownership is heavily skewed toward the top of the income distribution, the bulk of any additional dividends would likely end up in the hands of high-income investors who tend to save rather than spend.<sup>53</sup> Similarly, any

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<sup>50</sup> Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. 108-27, § 302, 117 Stat. 752, 760 (codified in scattered sections of 26 U.S.C.) (amending I.R.C. § 1(h) and reducing maximum rate on dividends and capital gain to 15%). Congress considered but failed to adopt the Administration’s original proposals. See H.R. 2, 108th Cong. § 201 (2003); S. 2, 108th Cong. § 201 (2003).

<sup>51</sup> William W. Bratton, *The New Dividend Puzzle*, 93 GEO. L.J. 845, 845 (2005); see also Jane G. Gravelle, *Effects of Dividend Relief on Economic Growth, the Stock Market, and Corporate Tax Preferences*, 56 NAT’L TAX J. 653, 659 (2003) (noting “an expectation that the rise in the stock market would spur spending in the short run”).

<sup>52</sup> See Gregg A. Esenwein & Jane G. Gravelle, *The Taxation of Dividend Income: An Overview and Economic Analysis of the Issues* 10, 12 n.12 (Cong. Research Serv., Report No. RL31597, 2007) (noting that in 1999, only 34% of total dividends paid by U.S. corporations showed up on U.S. individual tax returns); see also William G. Gale & Peter R. Orszag, *The Administration’s Proposal to Cut Dividend and Capital Gains Taxes*, 98 TAX NOTES 415, 416 (Jan. 20, 2003) (noting that at least half of all dividends “are effectively untaxed at the individual level because they flow to pension funds, 401(k) plans, and nonprofits”).

<sup>53</sup> See Esenwein & Gravelle, *supra* note 52, at 7–8 & tbl.1 (noting that more than 40% of dividends go to the top 2% of returns with income over \$200,000 and nearly 80% to the top 25% of returns with income over \$50,000); Jane G. Gravelle, *Dividend Tax Relief: Effects on Economic Recovery, Long-Term Growth, and the Stock Market* 2–3 (Cong. Research Serv., Report No. RL31824, 2007) (describing dividend tax relief

one-time rise in stock prices would result in a windfall gain to high-income investors, which would be difficult to justify in the absence of an increase in spending. Indeed, depending on how dividend taxes are viewed, a dividend exclusion might be expected to have a relatively small effect on stock prices (and hence on windfall gains and spending).<sup>54</sup> Furthermore, to the extent that tax cuts result in increased deficits, any long-run effect on economic growth might well be negative.<sup>55</sup>

*Tax Shelters and Retention.* Economists have long recognized that the double-level corporate tax system creates economic distortions.<sup>56</sup> Under the existing system, some corporate income is taxed twice (at both the corporate and shareholder levels), some is taxed only once (at either the corporate or shareholder level), and some is never taxed at all (or taxed only at preferential rates).<sup>57</sup> Although the

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as “one of the least effective tax cuts for encouraging investment spending”).

<sup>54</sup> See Gravelle, *supra* note 53, at 12 (arguing that the impact of the dividend exclusion proposal on the stock market would likely be “small compared to normal fluctuations in market values”). The “traditional” view of dividends, reflected in the original Treasury study of corporate integration, assumes that a dollar invested in corporate stock will increase share value by one dollar (all else being equal). By contrast, under the “new” view of dividends, the burden of the corporate tax is assumed to be capitalized in the price of stock. See Michael J. Graetz & Alvin C. Warren, Jr., *Integration of Corporate and Individual Income Taxes: An Introduction to the Issues*, in *INTEGRATION OF THE U.S. CORPORATE AND INDIVIDUAL INCOME TAXES: THE TREASURY DEPARTMENT AND AMERICAN LAW INSTITUTE REPORTS 3*, 17 (Michael J. Graetz & Alvin C. Warren, Jr. eds., 1998). The greater the stock market increase from lifting the burden of the double tax, the smaller the expected efficiency gain. See Gravelle, *supra* note 53, at 11.

<sup>55</sup> See William G. Gale & Peter R. Orszag, *An Economic Assessment of Tax Policy in the Bush Administration, 2001-2004*, 45 B.C. L. REV. 1157, 1204 (2004) (noting that even supporters of 2003 tax cuts acknowledged that efficiency gains were “likely to be small”); Gravelle, *supra* note 51, at 667 (“[The] long run growth effects [of the dividend exclusion proposal] are negative if it is deficit financed (and may be negative even if it is not).”).

<sup>56</sup> The double-tax system is widely viewed as distorting several types of investment and management decisions, including: (1) the choice between investment in corporate and noncorporate form; (2) the choice between debt and equity; (3) the choice between retention and distribution of corporate earnings; and (4) the choice between dividend and nondividend distributions. See FY 2004 REVENUE PROPOSALS, *supra* note 49, at 11. The Treasury also asserted that the double-tax system increases incentives for corporations to engage in shelter transactions to minimize their tax liability. See *id.*

<sup>57</sup> Tax shelter activity is viewed as playing a significant role in the growing gap between corporate “book” and “tax” income. See generally Mihir A. Desai, *The Divergence Between Book Income and Tax Income*, in 17 TAX POLICY AND THE

Administration did not directly attack corporate “preferences” that reduce effective tax rates at the corporate level, it touted its proposal as a way to ensure that corporate income would be taxed “once and only once,” with the added benefit of protecting the tax base by curbing corporate tax shelters.<sup>58</sup>

The centerpiece of the Administration’s proposal was a shareholder-level exclusion for dividends paid from income that was fully taxed at the corporate level.<sup>59</sup> Dividends from fully-sheltered corporate earnings would continue to be taxed to shareholders at ordinary income rates, resulting in a single-level tax, albeit at the shareholder’s marginal rate.<sup>60</sup> To maintain neutrality between distributed and retained earnings, the proposal would allow shareholders to increase the basis of their stock to reflect a ratable share of fully-taxed retained earnings, just as if those earnings had actually been received tax-free as a dividend and then reinvested.<sup>61</sup> Thus, it would make no difference to shareholders whether corporate earnings were paid out currently as dividends or extracted in nondividend form. To illustrate, suppose a corporation has \$100 of pre-tax income that it can either distribute or retain; assume further that all investments earn the same pre-tax return, and the corporation and all its shareholders are taxed on ordinary income at a 30% rate. If the corporation pays a \$30 tax, it can distribute the remaining \$70 to its shareholders as a fully excludable dividend. Alternatively, if the corporation retains the \$70 (and any investment returns) for future share repurchases, the shareholders can adjust their stock basis

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ECONOMY 169 (James M. Poterba ed., 2003).

<sup>58</sup> See FY 2004 REVENUE PROPOSALS, *supra* note 49, at 12 (noting that the proposal would “reduce incentives for certain types of corporate planning” because “shareholders will be exempt from tax only on distributions of previously taxed corporate income”).

<sup>59</sup> Under the proposal, a corporation would compute an “excludable dividend amount” based on its U.S. income tax for the previous year and the maximum corporate tax rate. This amount, reflecting fully-taxed corporate income, would establish a ceiling on the amount that the corporation could either distribute currently as excludable dividends or allocate to “retained earnings basis adjustments.” See *id.* at 13–15.

<sup>60</sup> Some corporate preferences reduce the effective tax rate at the corporate level without eliminating the tax entirely. For example, if a corporation earns \$100 of preference income that escapes regular tax but attracts a 20% alternative minimum tax, the \$100 of preference income can be bifurcated into \$57.14 of fully-taxed income (generating \$20 of tax at the regular 35%) and \$42.86 of zero-taxed income.

<sup>61</sup> See FY 2004 REVENUE PROPOSALS, *supra* note 49, at 14 (describing “retained earnings basis adjustments”).

upward to reflect the corporation's fully-taxed earnings and pay no tax on the subsequent repurchase. Thus, in the simplest case where earnings are fully taxed at the corporate level, the Administration's proposal would generally achieve parity between distribution and retention and eliminate the shareholder-level tax.<sup>62</sup>

Contrary to the Administration's claims, however, the proposal did not curb incentives for corporate managers to retain tax-sheltered corporate earnings, nor did it neutralize the advantage to shareholders of extracting such earnings at preferential capital gains rates.<sup>63</sup> If a corporation has fully-sheltered earnings of \$100, a current distribution would incur a shareholder-level tax of \$30, leaving \$70 after tax. The "proxy" tax at the shareholder level could readily be circumvented, however, if the corporation retained \$100 of tax-sheltered earnings to repurchase shares in the future instead of making a current distribution. Assuming that capital gains are taxed at a 15% rate, the shareholders would incur a tax of only \$15 on a share repurchase, leaving them with \$15 more after tax than in the case of a current distribution.<sup>64</sup>

The advantage of share repurchases could easily be eliminated by imposing a corporate-level "compensatory tax" on dividends or nondividend distributions from earnings that were not fully taxed at the corporate level.<sup>65</sup> On a share repurchase, a compensatory tax of \$30 at the corporate level would leave \$70 of after-tax earnings eligible for exclusion at the shareholder level. Without such a compensatory tax, the Administration's proposal preserved the tax advantages of sheltering and retaining corporate earnings. Since

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<sup>62</sup> Despite the Administration's proclaimed goal of increasing dividend distributions, the basis increase for retained earnings was intended to avoid a bias in favor of distribution. *See id.* at 12.

<sup>63</sup> *See* Gale & Orszag, *supra* note 52, at 419.

<sup>64</sup> Unlike a nonexcludable dividend, a share repurchase would permit ratable basis recovery. The advantage of share repurchases would be magnified to the extent that tax is deferred until realization, since the accrual-equivalent capital gain rate is significantly less than the nominal capital gain rate. *See id.* at 420 (noting that one solution would involve "taxing dividends and accruing capital gains at the full corporate tax rate to the extent such capital gains or dividends reflected income not already taxed at the corporate level").

<sup>65</sup> *See* ALVIN C. WARREN, JR., AM. LAW INST., FEDERAL INCOME TAX PROJECT: INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES, REPORTER'S STUDY OF CORPORATE TAX INTEGRATION 67-69 (1993). Assuming a 30% corporate tax rate ( $c$ ), a \$70 excludable dividend would imply \$100 of pre-tax corporate earnings, i.e.,  $\$70 \times 1/(1 - c)$ , and the corporation would owe a compensatory tax of \$30 ( $\$100 \times 30\%$ ) less any corporate taxes actually paid (zero).

shareholders can extract corporate earnings through stock sales (or nondividend distributions treated as stock sales), proponents of corporate integration often insist that capital gains from stock sales be taxed at the same rate as ordinary income.<sup>66</sup> Significantly, however, the Administration did not consider eliminating the preferential treatment of capital gains.<sup>67</sup>

*Dividend Surge and Corporate Governance.* The Administration claimed that abolishing the dividend tax would “transform corporate behavior” and “encourage responsible practices” by unleashing an increased flow of dividend payouts.<sup>68</sup> This claim combines two distinct arguments. The first argument concerns the purported obstacle to dividend distributions arising from the double-level corporate tax.<sup>69</sup> It is true that both the level of dividend payouts and the number of dividend-paying corporations have declined in recent years,<sup>70</sup> and that eliminating the shareholder-level tax on previously-taxed corporate earnings would make dividends relatively more attractive to shareholders. Nevertheless, corporate managers might prefer to retain earnings rather than make current distributions, as a matter of business judgment, if a corporation has higher-yield investment opportunities or a lower effective ordinary income tax rate than its

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<sup>66</sup> See, e.g., *id.* at 129–31 (Proposal 6).

<sup>67</sup> To the extent that “the most compelling argument for lower capital gains tax rates on corporate stocks is as an offset to double taxation,” elimination of double taxation would leave “no good reason to retain a tax preference for capital gains.” Leonard E. Burman, *Taxing Capital Income Once*, 98 TAX NOTES 751, 751–52 (Feb. 3, 2003).

<sup>68</sup> Richard B. Cheney, Vice President’s Remarks on Growth and Jobs Package at U.S. Chamber of Commerce (Jan. 10, 2003), available at <http://www.whitehouse.gov/news/releases/2003/01/20030110-5.html>; see also FY 2004 REVENUE PROPOSALS, *supra* note 49, at 12 (arguing that such a proposal would “enhance corporate governance” and increase “accountability of corporate management to its investors” by eliminating any bias against dividends).

<sup>69</sup> See Steven A. Bank, *Is Double Taxation a Scapegoat for Declining Dividends? Evidence from History*, 56 TAX L. REV. 463, 465 (2003) (“Many observers blame the double taxation of corporate income for the disappearance of dividends.”). There is, however, “no simple answer” to the question whether the double tax discourages distributions because the results depend on the relationship between corporate, individual, and capital gains tax rates as well as on nontax reasons for retaining or distributing earnings. WARREN, *supra* note 65, at 33.

<sup>70</sup> See Eugene F. Fama & Kenneth R. French, *Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay?*, 60 J. FIN. ECON. 3, 4, 7 (2001). Part of the decline in dividend payments may be attributable to the increased use of stock repurchases, although the latter are not perfect substitutes for ordinary dividends. See Bank, *supra* note 69, at 464–65; Bratton, *supra* note 51, at 846.

shareholders, or if earnings can be paid out at a lower tax cost through share repurchases. Although a dividend exclusion might increase shareholder demand for current distributions, there is little reason to believe that shareholder tax effects figure prominently in management decisions to retain or distribute corporate earnings.<sup>71</sup> Moreover, even if the Administration's proposal had its intended effect, there is no assurance that giving "shareholders, rather than executives, a greater degree of control over how a company's resources are used"<sup>72</sup> would enhance allocative efficiency.

The second argument involves the agency cost problem that arises when a manager's decision to retain or distribute corporate earnings is potentially tainted by a conflict of interest. Corporate managers who hold compensatory stock options may prefer to retain earnings for future share repurchases, both to avoid diluting the price per share and to obscure the full cost of their compensation.<sup>73</sup> Given the limited state of knowledge about the relationship between dividend taxes, executive compensation, and corporate governance, it seems at best simplistic for the Administration to propose eliminating the shareholder-level dividend tax to cure problems of corporate governance. Indeed, the prospect of shareholders rising up to demand tax-free dividends as a way of disciplining self-interested corporate managers borders on the fanciful. In short, the Administration's proposed dividend exclusion seems an exceedingly blunt instrument to achieve the stated goals of stimulating a surge of dividends and reforming corporate governance.<sup>74</sup> If those goals are taken seriously, a narrowly-tailored solution aimed directly at specific practices or

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<sup>71</sup> See Bratton, *supra* note 51, at 847 ("But, in practice, tax considerations influence payouts only marginally. Managers making payout choices do not try to minimize shareholder income taxes.").

<sup>72</sup> JOINT ECON. COMM., 108TH CONG., DIVIDEND TAX RELIEF AND CAPPED EXCLUSIONS 1 (2003); see also ECONOMIC REPORT OF THE PRESIDENT 204 (2003) ("Dividend payments may also be one way for shareholders to impose discipline on corporate managers: reducing the amount of cash at the discretion of management may focus management's attention on the most productive investments rather than on purchases that may not increase shareholder value.").

<sup>73</sup> See Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325, 350-51 (1995); Bratton, *supra* note 51, at 875 (noting that stock options "giv[e] managers a strong incentive to prefer repurchases").

<sup>74</sup> See Steven A. Bank, *Dividends and Tax Policy in the Long Run*, 2007 U. ILL. L. REV. 533, 574 ("[I]t might make more sense to rethink whether increased dividends specifically, and corporate governance benefits more broadly, should be the goal at all when it comes to the Tax Code.").

sectors in need of reform would almost certainly prove less costly and more fruitful.

### B. Perceptions of Fairness

*Double Tax.* In promoting its dividend exclusion proposal, the Administration adopted the same moralistic tone that it had used so effectively in attacking the estate tax two years earlier. According to the Administration, it was “not fair” to tax corporate profits at both the corporate and shareholder levels — double taxation was simply “wrong.”<sup>75</sup> By tacitly assuming that all corporate income was taxed at the corporate level, the rhetoric of double taxation obscured the fundamental issue of untaxed (or undertaxed) corporate income.<sup>76</sup> A substantial portion of corporate income escapes tax at the corporate level as a result of tax shelters and preferential treatment for accelerated depreciation and other outlays. Since the effective corporate tax rate is considerably less than the maximum individual rate, individuals can enhance their after-tax returns by investing through corporations and choosing when to realize gains at the shareholder level. Shareholder-level gains are generally taxed at preferential rates, and indeed may escape tax altogether if stock is retained until death. As a result, the combined burden of the double-level corporate tax likely is not significantly heavier than a single-level individual tax on ordinary income.<sup>77</sup> Ironically, the Administration’s

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<sup>75</sup> Bush, *supra* note 49, at 110 (“It’s fair to tax a company’s profits. It is not fair to again tax the shareholder on the same profits. . . . I ask you to end the unfair double taxation of dividends.”); White House, Office of the Press Secretary, Background Briefing on the Growth and Jobs Plan (Jan. 7, 2003), *available at* <http://www.whitehouse.gov/news/releases/2003/01/print/20030107-3.html> (“If it’s wrong to have double taxation, it’s wrong to [have] any level of double taxation, whether it’s 50 percent or 100 percent.”); White House, Office of the Press Secretary, *supra* note 49 (“Double taxation is wrong — and it falls hardest on seniors.”).

<sup>76</sup> George W. Bush, Remarks to the Economic Club of Chicago in Chicago, Illinois, 39 WEEKLY COMP. PRES. DOCS. 33, 36 (Jan. 7, 2003) (“First, the IRS taxes a company on its profit. Then it taxes the investors who receive the profits as dividends. The result of this double taxation is that for all the profit a company earns, shareholders who receive dividends keep as little as 40 cents on the dollar.”); *cf.* Gale & Orszag, *supra* note 52, at 416 (“In fact, however, most corporate income is not taxed twice . . . .”); Alan J. Auerbach, *Who Bears the Corporate Tax? A Review of What We Know* 25 (Nat’l Bureau of Econ. Research, Working Paper No. 11686, 2005) (“[H]aving two levels of tax on corporate-source income doesn’t necessarily imply double taxation of that income, in the sense of a cascade of corporate and individual rates.”).

<sup>77</sup> See Auerbach, *supra* note 76, at 25 (“[Some investors] face marginal tax rates



dividend exclusion proposal did not address the treatment of pension plans, 401(k)s, or individual retirement accounts, which accumulate investment earnings tax-free but ultimately must make distributions that are fully taxable as ordinary income to individual participants.<sup>78</sup>

*Fairness to Investors.* The Administration also argued that it was unfair to impose two levels of tax on corporate stock while direct investments in bonds and real estate were subject to only one level of tax.<sup>79</sup> Economists generally reject such arguments on the ground that disparities in the tax burdens on different investments are capitalized in the respective purchase prices.<sup>80</sup> To the extent that the burden of the corporate tax is shifted to all capital income in the long run, the more salient arguments about the fairness of a dividend exclusion focus on distributional effects, windfall gains to existing investors, and alternative sources of revenue.<sup>81</sup> Oblivious of these issues, the Administration merely repeated the refrain that the proposed tax cuts would “pay for themselves” — a claim that nearly all economists dismissed as wishful thinking.<sup>82</sup>

The fairness norm underlying the Administration’s proposed dividend exclusion evidently contemplated that all corporate source income should be taxed uniformly, without regard to the individual shareholder’s marginal tax rate.<sup>83</sup> This norm, however, is fundamentally incompatible with a system that applies progressive

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on corporate-source income that are little higher or even lower than their tax rates on ordinary income.”).

<sup>78</sup> Although amounts withdrawn from a traditional 401(k) are fully taxable, the investment earnings are effectively exempt from tax since, assuming constant tax rates, the tax saving on the deductible contribution equals the present value of the tax liability on withdrawal. See 1992 INTEGRATION STUDY, *supra* note 49, at 25 (noting that, under dividend exclusion proposal, disincentive for investing pension funds in corporate stock would be “no greater than under current law”).

<sup>79</sup> See Bush, *supra* note 76, at 36 (“[W]e have an obligation to make sure . . . that American investors are treated fairly. We can begin by treating investors fairly and equally in our tax laws.”).

<sup>80</sup> See Arlen & Weiss, *supra* note 73, at 326 n.2 (“[U]nlike vertical inequities, horizontal inequities are often arbitrated away by the market price mechanism.”); Esenwein & Gravelle, *supra* note 52, at 5.

<sup>81</sup> See Gravelle, *supra* note 51, at 655.

<sup>82</sup> See Gale & Orszag, *supra* note 55, at 1166–68; Katherine Pratt, *Deficits and the Dividend Tax Cut: Tax Policy as the Handmaiden of Budget Policy*, 41 GA. L. REV. 503, 575 n.457 (2007).

<sup>83</sup> See 1992 INTEGRATION STUDY, *supra* note 49, at 13. The Administration was apparently unconcerned about any potential unfairness to shareholders who face marginal rates lower than the corporate tax rate. See *id.* at 22 (dismissing concerns about low-income shareholders).

rates to a comprehensive income tax base.<sup>84</sup> Skeptics who pointed out that high-income taxpayers would benefit disproportionately from a dividend exclusion were accused of fomenting “class warfare.”<sup>85</sup> The Administration tried to parry distributional concerns by suggesting — without a shred of empirical evidence — that the dividend tax imposed a disproportionate burden on the elderly.<sup>86</sup> In fact, while some high-income elderly undoubtedly receive large amounts of dividend income, nearly 80% of individuals over age sixty-five receive no dividend income.<sup>87</sup>

*“It’s Your Money.”* Tapping into the myth that blamed the double-level corporate tax for declining dividend payouts,<sup>88</sup> boosters claimed that the Administration’s proposal would release a flood of dividends to be invested more profitably by individual shareholders.<sup>89</sup> The Administration took pains to suggest that benefits would flow not just to a few wealthy individuals but to millions of small investors as well.<sup>90</sup> Thus, the dividend exclusion was intended to appeal broadly to the “investor class,” conjuring up a ready source of funds that would

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<sup>84</sup> See WARREN, *supra* note 65, at 49 (rejecting dividend exclusion approach “because it would preclude the application of graduated rates to individual investors”).

<sup>85</sup> See White House, Office of the Press Secretary, *supra* note 75 (agreeing that some Democrats who criticized the Administration’s proposal on distributional grounds were “engag[ed] in class warfare”).

<sup>86</sup> See Bush, *supra* note 76, at 36 (“Double taxation is wrong. Double taxation falls especially hard on retired people. About half of all dividend income goes to America’s seniors, and they often rely on those checks for a steady source of income in their retirement.”); White House, Office of the Press Secretary, *supra* note 49 (“Almost half of all savings from the dividend exclusion under the President’s plan would go to taxpayers 65 and older. The average tax savings for the 9.8 million seniors receiving dividends would be \$936.”).

<sup>87</sup> See Esenwein & Gravelle, *supra* note 52, at 8–9 (“[I]n 2000, only 21 percent of individuals aged 65 or older actually received dividend income.”). Since far more low- and middle-income elderly rely on interest income than on dividends, the Administration could have provided more effective broad-based tax relief for this group — if that was its goal — through a modest interest exclusion. See *id.*

<sup>88</sup> See Bank, *supra* note 69, at 466 (referring to notion that double taxation causes retained earnings to be trapped in corporation as a “myth”). Historically, double taxation may be viewed as “the result of the retained earnings problem rather than its cause.” *Id.* at 532.

<sup>89</sup> See H.R. REP. NO. 108-94, at 31 (2003) (arguing that dividend tax discourages dividends “even if the shareholder might have an alternative use for the funds that could offer a higher rate of return than that earned on the retained earnings”).

<sup>90</sup> See White House, Office of the Press Secretary, *supra* note 49 (“More than 40 percent of people who receive dividends make under \$50,000 per year — and three-fourths make less than \$100,000 per year.”).

simultaneously stimulate consumer spending and spur investment and economic growth.<sup>91</sup> The notion that a dividend exclusion would induce a surge in dividend payouts as well as an increase in share prices reflects a fundamental confusion of two alternative views of corporate dividends. The “traditional” view holds that the tax cost of dividends to shareholders is offset by nontax benefits (e.g., signaling strength to capital markets), and predicts that a dividend tax cut should trigger increased dividend payouts but have no significant effect on share prices.<sup>92</sup> By contrast, the “new” view holds that dividends have no nontax benefits to shareholders relative to retained earnings but merely represent a residual use of corporate earnings after other profitable opportunities are exhausted. The new view therefore implies that a dividend tax cut should have no effect on the decision to retain or distribute corporate earnings but should produce a windfall gain to existing shareholders by raising share prices.<sup>93</sup> By claiming that a dividend exclusion would stimulate both consumption and saving, the Administration gave the impression that investors could eat their cake and have it too.

### C. The Fifteen Percent Solution

The Administration’s original dividend exclusion proposal was designed to ensure that corporate earnings would be taxed once and only once, at either the corporate level or the shareholder level. To accomplish this goal, the proposal required a special account to keep track of the tax paid on earnings at the corporate level, and shielded tax-paid earnings from tax at the shareholder level through a dividend exclusion (for distributed earnings) or a step-up in stock basis (for retained earnings).<sup>94</sup> Whatever its merits as a corporate integration

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<sup>91</sup> See Bruce Bartlett, *Bush’s Tax Cuts for Investors Will Boost Market*, WALL ST. J., Aug. 26, 2002, at A10 (referring to “investor class”); Henry M. Paulson, Jr., *Good For All Americans*, WALL ST. J., Mar. 19, 2003, at A14 (arguing that repeal of dividend tax “will not only place more money in taxpayers’ pockets but immediately result in higher equity prices”).

<sup>92</sup> See WARREN, *supra* note 65, at 37 (noting that a reduction in dividend taxes may “be associated with an increase in dividends under the traditional, but not the new, view of corporate finance”).

<sup>93</sup> See Alan J. Auerbach & Kevin A. Hassett, *On the Marginal Source of Investment Funds*, 87 J. PUB. ECON. 205, 216 (2003) (noting new view’s “prediction that the level of dividend taxes has no impact on the incentive to invest or pay dividends”).

<sup>94</sup> The proposal was essentially a warmed-over version of a corporate integration plan developed by the Treasury Department under President George H.W. Bush. See

measure, the proposal failed to attract support from any major political constituency. Instead, the proposal met stiff resistance from business interest groups which saw it as complex, burdensome, and inimical to corporate-level tax preferences.<sup>95</sup> Mounting criticism from groups representing major industries — life insurance, real estate, municipal bonds, low-income housing, and pension plans, to name a few — fueled doubts about the prospects for enacting a dividend exclusion. The Administration sought to reassert control over the tax-cutting agenda by launching an aggressive lobbying campaign, spearheaded by the same tax-cutting coalition that had proved so effective in 2001.

In the Senate, the main source of opposition to the proposal was its revenue cost. As a condition for supporting the budget resolution, two pivotal Republican senators extracted a promise from Finance Committee Chairman Charles Grassley to limit the cost of any tax cut package in conference to \$350 billion — well below the \$550 billion allowed by the budget resolution and less than half of the \$726 billion package sought by the Administration.<sup>96</sup> In order to comply with the self-imposed \$350 billion cap, Grassley's committee reported a bill that included a pared-down dividend exclusion coupled with several corporate tax offsets.<sup>97</sup> For business groups, the offsets in the Grassley bill heaped insult on injury by increasing taxes at the corporate level to make room for tax cuts for individual investors. Disenchantment with the bill splintered the tax-cutting coalition, which released its constituents from their earlier pledge to cooperate with the Administration.

In the House, the Administration's proposal met a skeptical response from Ways and Means Committee Chairman William Thomas, who was more interested in a capital gains rate cut than in corporate integration.<sup>98</sup> Thomas marked up the House bill to provide

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1992 INTEGRATION STUDY, *supra* note 49; FY 2004 REVENUE PROPOSALS, *supra* note 49.

<sup>95</sup> See Steven A. Bank, *A Capital Lock-In Theory of the Corporate Income Tax*, 94 GEO. L.J. 889, 942 (2006); see also Arlen & Weiss, *supra* note 73, at 326–27 (noting that prior attempts at corporate integration have “died a quiet death”).

<sup>96</sup> See Allison Stevens & Andrew Taylor, *What Led to the GOP Leadership Rift*, CQ WEEKLY, Apr. 19, 2003, at 933.

<sup>97</sup> The bill reported by the Finance Committee provided for an exclusion limited to the greater of \$500 or 10% of qualified dividend income (rising to 20% in 2008). See S. 1054, 108th Cong. (2003). After offsets, the net revenue cost of the bill was \$350 billion. See Stevens & Taylor, *supra* note 96.

<sup>98</sup> See Patti Mohr & Warren Rojas, *House and Senate Offer Different Paths to Dividend Reductions*, 99 TAX NOTES 591 (May 5, 2003) (discussing concerns about the

a straightforward tax rate cut for capital gains and dividends, without regard to whether earnings were taxed at the corporate level. This approach abandoned any pretense of corporate integration, but it was undeniably simpler than the Administration's proposal. More importantly, it offered a politically potent combination of tax cuts that benefited investors without jeopardizing existing corporate tax preferences, and thereby avoided playing favorites among business interests. A generous increase in bonus depreciation for business investments enhanced its appeal to business groups. Despite strong objections from the Administration, Thomas's proposal prevailed in the House bill reported by the Ways and Means Committee.<sup>99</sup>

Sidelined in the House by Thomas's proposal and blindsided in the Senate by Grassley's side deal with deficit hawks, the Administration fought hard to keep the idea of a full dividend exclusion in play. During the Senate debate on Grassley's bill, Senator Don Nickles sponsored a floor amendment to provide a dividend exclusion beginning at 50% in 2003, rising to 100% for the next three years, and then expiring at the end of 2006. The Nickles amendment was far more aggressive and costly than the modest exclusion in Grassley's original bill, and had nothing to do with corporate integration. Nevertheless, Senator Nickles urged his colleagues to support the amendment because it would "accomplish the President's objective of eliminating double taxation of dividends."<sup>100</sup> At the eleventh hour and by the narrowest possible margin, Nickles prevailed.<sup>101</sup>

Even staunch supporters of tax cuts were appalled, and derided the disappearing dividend exclusion in the Senate bill as "one of the most patently absurd tax policies ever proposed."<sup>102</sup> The phase-in and

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structure and effects of the Administration proposal); Jonathan Weisman, *Thomas Questions Dividend Tax Cuts*, WASH. POST, Jan. 28, 2003, at A4 (noting concerns about the potential impact of the Administration proposal on investor behavior and corporate management).

<sup>99</sup> See H. REP. NO. 108-94 (2003).

<sup>100</sup> See 149 CONG. REC. S6433 (daily ed. May 15, 2003) (remarks of Sen. Nickles); *id.* ("[I]t is what the President wants.").

<sup>101</sup> The Nickles amendment passed by a 51-50 vote, with Vice President Cheney casting the deciding vote. See *id.* The amended bill ultimately passed the Senate by a 51-49 vote. See *id.* at S6474.

<sup>102</sup> 149 CONG. REC. S6433 (daily ed. May 15, 2003) (remarks of Sen. Baucus, quoting Kevin Hassett of the American Enterprise Institute); see also BRUCE BARTLETT, *IMPOSTOR: HOW GEORGE W. BUSH BANKRUPTED AMERICA AND BETRAYED THE REAGAN LEGACY* 60-62 (2006) (noting that the Administration's insistence "on making dividends fully tax-free even if only for a single year, in hopes

subsequent termination of the exclusion would encourage corporations to manipulate the timing of dividend payments to bring them within the three-year window of full excludability, producing a temporary spike in dividend payouts followed by a sharp decline — clearly at odds with the Administration's stated goal of promoting steady dividend payouts. If the sunset provision was taken at face value, the bill would disrupt corporate decisions about retaining or distributing earnings and increase the volatility of stock prices. On the other hand, if (as the Administration apparently intended) the sunset provision was merely a gimmick to make room for a permanent, complete dividend exclusion, the revenue cost would far exceed anything contemplated by Congress. A debt-financed tax cut would not promote long-term economic growth. Nor could the bill be defended as providing economic stimulus, given the delay in phasing in a full dividend exclusion. Instead, the primary effects of allowing a full exclusion for dividends paid from tax-sheltered corporate earnings would be to introduce new distortions into the behavior of corporate managers and investors.

Although the Senate bill lacked a coherent rationale or policy justification, it had one obvious political advantage: it allowed the Administration to save face and declare victory, however fleeting, in its quest to abolish the shareholder-level tax on dividends. In reality, the Administration had lost the confidence of crucial business groups and forfeited the ability to dictate the shape of any major tax cuts. From the outset, most business groups were more interested in sheltering income at the corporate level than reducing the shareholder-level tax on dividends. Having stood aside in 2001 to make way for individual income tax cuts, they refused to be put off a second time.<sup>103</sup> Not surprisingly, these business groups threw their support behind the House bill, which provided a hefty increase in bonus depreciation along with a maximum 15% rate on dividends and capital gains. Even the brokerage and mutual fund industries, which stood to gain the most from a full dividend exclusion, found nothing to

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that it could extend the provision in later years" baffled even supporters); Alan Reynolds, *Tax Cut Priorities*, available at [http://www.cato.org/pub\\_display.php?pub\\_id=3097](http://www.cato.org/pub_display.php?pub_id=3097) (arguing that the Administration's "all-or-nothing approach" showed failure of leadership and decrying "goofy gimmicks" like sunset provisions).

<sup>103</sup> See Martin A. Sullivan, *Dividend Déjà Vu: Will Double Tax Relief Get Canned — Again?*, 98 TAX NOTES 645, 645–46 (Feb. 3, 2003) (noting that Republican lawmakers "are getting the word from a wide variety of business interests that a dividend exclusion is not what they — after being shut out of the big tax cuts enacted in 2001 — had in mind as the long-awaited tax cut for business").

complain of in the House bill. The real issue was whether Senator Grassley would hold to his promise to limit the revenue cost of the tax cuts in conference and, if so, whether the essential features of the House bill could be crammed into a \$350 billion package. In the end, the conference agreement followed the House bill. The 15% maximum rate on dividends and capital gains remained intact, and the conferees brought the overall revenue cost down to \$350 billion by terminating all of the tax cuts at the end of 2008. The final bill passed largely along partisan lines, with Vice President Cheney casting a tie-breaking vote in the Senate.<sup>104</sup>

Despite the Administration's protestations to the contrary, the 2003 Act hardly represents "a step toward fundamental tax reform."<sup>105</sup> For all the brinkmanship surrounding its passage, the 2003 Act does not eliminate the double-level tax on corporate earnings but merely reduces the maximum tax rate on dividends and capital gains to 15% (and only for a few years).<sup>106</sup> By cutting the shareholder-level dividend tax without ensuring that earnings would be fully taxed at the corporate level, the Administration "gave the carrot away" and squandered its best opportunity to achieve corporate integration.<sup>107</sup> Far from making the tax system simpler and more efficient, the 2003 Act opens up fresh opportunities for tax avoidance and invites financial technicians to discover new ways to convert compensation, interest, and other ordinary income into tax-favored dividends.<sup>108</sup>

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<sup>104</sup> The conference agreement passed in the House by a vote of 231-200. See 149 CONG. REC. H4729 (daily ed. May 22, 2003). The vote in the Senate was 51-50. See 149 CONG. REC. S7087 (daily ed. May 23, 2003).

<sup>105</sup> John D. McKinnon, *The 2003 Tax Package: Tax Cut Embodies Political Agenda*, WALL ST. J., May 27, 2003, at A2 (quoting R. Glenn Hubbard, former chairman of President's Council of Economic Advisers).

<sup>106</sup> The rate cuts were originally scheduled to expire at the end of 2008 but in 2006 were extended until the end of 2010. See Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 303, 117 Stat. 752, 764 (2003) (codified as amended in scattered sections of 26 U.S.C.); Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 102, 120 Stat. 345, 346 (2006) (codified in scattered sections of 26 U.S.C.).

<sup>107</sup> See Gale & Orszag, *supra* note 55, at 1230 (noting that "the dividend tax cut undermines the political viability of true corporate tax reform" because it fails "to combine the carrot of addressing the 'double taxation' of dividends with the stick of closing corporate loopholes and preferential tax provisions, to ensure that corporate income is taxed once and only once — but at least once"); R. Glenn Hubbard, *Economic Effects of the 2003 Partial Integration Proposal in the United States*, 12 INT'L TAX & PUB. FIN. 97, 97 (2005) (noting failure to condition dividend rate cut on payment of corporate tax).

<sup>108</sup> For example, a wealthy investor could borrow to purchase stock, deduct the

The Administration argues that the 2003 Act unleashed an “unprecedented” surge in dividend payouts, raised stock prices, and stimulated economic growth,<sup>109</sup> but this account is incomplete and misleading. Although dividends have indeed increased in recent years, the rebound appears to have begun as early as 2000, well before any sign of a dividend tax cut.<sup>110</sup> Dividends have grown “much more slowly than corporate profits” since 2003, and in historical context the increase appears unremarkable.<sup>111</sup> According to recent studies, only a small number of firms increased dividend payouts as a result of the tax cuts, and the response was strongest in firms where executives, directors, or taxable institutional investors were able to influence dividend policy for their own benefit.<sup>112</sup> In other words, instead of

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interest expense against other investment income, and exclude the dividends from stock purchased with borrowed funds. See David Wessel, *Capital: Dividend-Tax Cut Runs Risk of Opening Doors to New Shelters*, WALL ST. J., May 22, 2003, at A2. Alternatively, at the death of a sole shareholder, the corporation could distribute accumulated earnings as a tax-free dividend to the heirs, who could then sell their stock, taking advantage of the § 1014 basis step-up to generate an artificial capital loss. See also New York State Bar Ass’n Tax Section, *Dividends Provisions of the Jobs and Growth Tax Relief Reconciliation Act of 2003*, 101 TAX NOTES 273, 276 (Oct. 13, 2003) (noting that extraordinary dividend rule “may not be adequate” to prevent taxpayers from effectively converting short-term capital gain into tax-favored dividend income).

<sup>109</sup> See ECONOMIC REPORT OF THE PRESIDENT 76 (2005); see also ECONOMIC REPORT OF THE PRESIDENT 72 (2007); U.S. DEP’T OF THE TREASURY, INVESTING IN AMERICA’S FUTURE: REPORT ON THE ECONOMIC EFFECTS OF CUTTING DIVIDEND AND CAPITAL GAINS TAXES IN 2003, at 9–10 (2006).

<sup>110</sup> See Brandon Julio & David L. Ikenberry, *Reappearing Dividends*, 16 J. APPLIED CORP. FIN. 89, 94 (2004) (noting that companies with established dividend policies started increasing payouts in 2001, and large-cap firms started increasing dividends in 2000); cf. U.S. DEP’T OF THE TREASURY, *supra* note 109, at 8 (“[T]rends of declining dividends reversed beginning in 2003 at the time the dividend tax cuts were enacted.”). The Administration’s explanation also ignores other factors, such as the shift away from option-based compensation toward stock-based compensation, which may have rendered dividends more attractive relative to share repurchases beginning around 2003. See Bank, *supra* note 74, at 552–53; Julio & Ikenberry, *supra*, at 106; Jennifer L. Blouin et al., *Did Dividends Increase Immediately After the 2003 Reduction in Tax Rates?* 25 (Nat’l Bureau of Econ. Research, Working Paper No. 10301, 2004).

<sup>111</sup> Gravelle, *supra* note 53, at 20.

<sup>112</sup> See Bank, *supra* note 74, at 551–52; Raj Chetty & Emmanuel Saez, *Dividend Taxes and Corporate Behavior: Evidence from the 2003 Dividend Tax Cut*, 120 Q.J. ECON. 791, 794 (2005); see also Blouin et al., *supra* note 110, at 4; Jeffrey R. Brown et al., *Executive Financial Incentives and Payout Policy: Firm Responses to the 2003 Dividend Tax Cut* 26–27 (Nat’l Bureau of Econ. Research, Working Paper No. 11002, 2004); cf. Bratton, *supra* note 51, at 857 (in a survey of chief financial officers of



benefiting a broad class of small individual investors, the dividend tax cut prompted increased dividend payouts primarily to corporate insiders and large shareholders.<sup>113</sup> Increased dividend payouts, of course, do not necessarily imply an equivalent increase in total corporate distributions, since dividends may substitute in part for share repurchases that would otherwise have occurred. Moreover, even assuming an increase in total corporate distributions, the impact on saving and investment is ambiguous, depending on whether individual shareholders consume or reinvest their distributions and whether the tax cut is financed with additional public debt or offset from other sources. In theory, increased dividend payouts are entirely compatible with unchanged levels of private saving, net investment, and economic growth.

Ever since President Bush signed the 2003 Act into law, the Administration has lobbied hard to make the tax cuts permanent. According to the Administration, failure to extend the dividend and capital gains tax cuts would have dire consequences for investor confidence, economic growth, and corporate governance.<sup>114</sup> This argument not only trivializes the budget constraints that gave rise to the sunset provisions in the 2003 Act in the first place, but also ignores potentially significant differences between the effects of a temporary dividend tax cut and those of a permanent tax cut.<sup>115</sup> A temporary dividend tax cut has the perverse effect of encouraging dividend

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dividend-paying firms, two-thirds reported that eliminating dividend tax “either definitely or probably would not” affect their payout decisions).

<sup>113</sup> The largest one-time payout was the record \$32 billion special dividend paid by Microsoft. See Gary Rivlin, *Microsoft to Pay Special Dividend to Stockholders*, N.Y. TIMES, July 21, 2004, at A1; see also Ken Brown, *As Taxes Fall, Dividends Rise — and Executives Reap Big Gains*, WALL ST. J., Aug. 11, 2003, at A1 (noting that Henry Paulson of Goldman Sachs and Charles Schwab of the eponymous brokerage firm, both prominent supporters of dividend tax cuts, received large dividend payouts, and that “after taking a public position, [their] companies felt obligated to boost their own dividends, effectively putting their money where their mouths were”); cf. Chetty & Saez, *supra* note 112, at 829 (“Corporations that had neither strong agent incentives nor large principals to induce a dividend policy change were virtually unresponsive to the [dividend tax cut].”).

<sup>114</sup> See ECONOMIC REPORT OF THE PRESIDENT 73–74 (2007) (complaining of the “impermanence” of the dividend and capital gains tax cuts and arguing that “to have lasting effects on investment and economic growth, these pro-growth policies should be made permanent”).

<sup>115</sup> See Bank, *supra* note 74, at 559–60 (noting that making the tax cut permanent would merely restore tax parity between current deferral and future distributions, eliminating a temporary incentive to distribute corporate earnings).

payouts in anticipation of an expected future rate increase.<sup>116</sup> Thus, for example, if the 2003 dividend tax cut is perceived as temporary, investors have an incentive to withdraw funds from corporate solution while the 15% maximum tax rate remains in force, and the incentive becomes stronger as it becomes more likely that the 15% rate will not become permanent. By contrast, under a permanent tax cut, investors would face the same tax burden regardless of whether the corporation distributed earnings currently as a dividend or retained those earnings and distributed them (with any accumulated income) in the future.<sup>117</sup>

Neutrality between distribution and retention of corporate earnings also depends crucially on the relationship between the respective tax rates on dividends and capital gains. Merely setting the dividend tax rate equal to the nominal capital gain tax rate does not eliminate the advantages of retention and repurchase over immediate distribution. Unlike dividends, stock repurchases allow individual shareholders to control the timing of realized gains, recover basis, offset capital losses, and potentially avoid tax altogether if stock is held until death.<sup>118</sup> Thus the rate parity imposed by the 2003 Act, even if perceived as permanent, may do little to cure the distortions that make the strategy of sheltering, retention, and repurchase attractive to corporate managers and shareholders alike.<sup>119</sup>

The sunset provisions of the 2003 Act, coupled with burgeoning budget deficits, create an unstable situation in which both dividend and capital gain rates may have to be raised in tandem. If future capital gain rates are expected to rise above the current dividend tax rate, the bias in favor of current distributions may become sufficiently strong to overcome the advantages of sheltering, retention, and repurchase. The 2003 Act would then be exposed as a one-time opportunity for shareholders to bail out corporate earnings on advantageous terms with no adequate compensatory tax at the corporate level. The 2003 tax cuts cannot be justified as a step toward efficiency-enhancing corporate integration or fundamental tax reform, because they leave corporate-level sheltering opportunities intact while conferring windfall gains on existing shareholders. Whether intended as a temporary stimulus measure or a down payment on a

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<sup>116</sup> See *id.* at 573 (noting that in the absence of tax rate parity between current and future distributions, the 2003 Act “offered firms an incentive to distribute dividends currently”).

<sup>117</sup> See WARREN, *supra* note 65, at 29–30 (stating assumptions for neutrality between retention and distribution).

<sup>118</sup> See Blouin et al., *supra* note 110, at 9–10.

<sup>119</sup> See Bratton, *supra* note 51, at 846–47.

long-term tax-cutting agenda, the 2003 Act makes little sense as a matter of tax policy.

#### IV. CONCLUSION

The Bush Administration was quick to portray the tax cuts of 2001 and 2003 as vindicating its ambitious tax reform agenda, even though the legislation enacted by Congress bore little resemblance to the Administration's original proposals. In fact, the legislative outcomes of 2001 and 2003 illustrate serious flaws in the Administration's tax cutting agenda. One basic problem arises from the Administration's tendency to formulate tax policy in terms of simplistic slogans such as "abolishing the death tax" or "eliminating double taxation of dividends."<sup>120</sup> These slogans may be effective marketing tools for propagating an ideological message and mobilizing political support, but they are no substitute for reasoned policy analysis. Unfortunately, the Administration's proposals to repeal the estate tax and eliminate the shareholder-level income tax on dividends seem to have been formulated in a vacuum, without any consideration of divergent views or competing goals. Indeed, in its zeal for abolishing selected forms of "double taxation," the Administration appears to have systematically refused to take account of revenue costs, distributional effects, and equity-efficiency tradeoffs.

The Administration has also pursued a confrontational, all-or-nothing approach which invites parliamentary brinkmanship while ignoring the realities of budget politics. Unable to muster a sixty-vote supermajority in the Senate, yet unwilling to negotiate a bipartisan compromise, the Administration and its allies in the congressional leadership have resorted to unprecedented budget gimmicks in an effort to meet the competing demands of numerous interest groups. The resulting legislation is hopelessly complex and inherently unstable — a travesty of the simple, straightforward, decisive tax cuts originally promised by the Administration. Instead of permanent estate tax repeal, the 2001 Act provides for a temporary one-year moratorium in 2010 — following an extended phase-out period and accompanied by complex new carryover basis provisions and a stand-alone gift tax. Likewise, far from achieving corporate integration through a dividend exclusion, the 2003 Act merely offers a temporary rate cut and leaves the double-level corporate tax in place, thereby opening new tax

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<sup>120</sup> See Wessel, *supra* note 108 (noting that the Bush Administration asked the Treasury Department "to turn a slogan — 'end the double taxation of dividends' — into tax policy").

shelter opportunities and conferring windfall gains on existing shareholders. Nevertheless, the Administration insists that the tax cuts of 2001 and 2003 should be made permanent, implying that their expiration would jeopardize future growth. Moreover, by arguing that the tax cuts were always intended to be permanent and that their expiration would be equivalent to a tax increase, the Administration seeks to avoid any accounting for lost revenues.

Despite record budget deficits and a widening fiscal gap, the Administration appears to have embraced “stay the course” as its new slogan-based tax policy. The tax cuts of 2001 and 2003 have accelerated a trend of growing inequality in income and wealth without yielding long-term efficiency gains. Anti-tax advocates have attempted to portray those tax cuts as part of a grand strategy to move the existing hybrid income-consumption tax system toward a flat-rate consumption tax. However, the notion of achieving fundamental tax reform in “five easy steps” amounts to little more than an after-the-fact rationalization for a series of attacks on progressive taxation. By pursuing tax cuts without revenue offsets or base-broadening measures, the Administration has exacerbated an already dire fiscal outlook and squandered an opportunity to achieve fundamental tax reform. As the era of illusory tax cuts draws to a close, it is high time to formulate a more realistic and sustainable tax policy.

